

## **1. BACKGROUND AND METHODOLOGY**

### **Performance audit background**

As a consequence of fiscal pressures and increases in citizen services, the North Carolina General Assembly recognized that it must reduce the costs of program service delivery and identify more efficient and effective ways of:

- Organizing, administering, and delivering services and programs
- Strengthening the financial planning, budgeting, and management systems
- Procuring and providing goods and services

The North Carolina General Assembly, in its 1991 session, authorized a year-long performance audit of all branches of State government to assist in evaluating government operations, restructuring and reforming service delivery, strengthening management practices, improving government efficiency and effectiveness, establishing priorities, and preserving and improving the quality of State services.

To facilitate the achievement of these goals, the Legislative Services Commission created a Government Performance Audit Committee (GPAC). GPAC is co-chaired by the Speaker of the House and President Pro Tempore of the Senate. In addition to the co-chairs, GPAC includes six members of the General Assembly, the State Auditor, and ten private sector leaders of North Carolina, who are organized in three subcommittees:

- Organization/staffing and personnel
- Planning, budgeting, program evaluation, and financial model
- Information technology/telecommunications and purchasing

The performance audit is organized into two phases. The objective of the first phase is to review the following five major management systems:

- Planning, budgeting, and program evaluation
- Personnel
- Purchasing
- Technology

- Organization and staffing patterns

GPAC engaged KPMG Peat Marwick to assist in conducting Phase I of the performance audit. To facilitate the work of each subcommittee, Peat Marwick formed six functional teams that correspond to the five major segments listed above. To provide perspective on the long-range financial health of the State, we developed a financial model for projecting General Fund revenues and expenditures by major program.

Each of the functional teams worked under the direction of the appropriate subcommittee and the GPAC Executive Director. Phase II analysis builds upon Phase I findings and recommendations. The Phase II analysis focuses on how program service delivery can be redesigned to achieve mission-related outcomes in the most cost-effective manner. Upon completion of Phase I, each functional team provided its respective audit committees with separate performance audit results and recommendations for Phase II analyses.

This performance audit report presents findings and recommendations related to the planning, budgeting, and program evaluation processes in North Carolina State government.

### **Planning, budgeting and program evaluation audit objectives**

The objectives of the Phase I performance audit of State planning, budgeting, and program evaluation processes were to:

- Determine the level of coordination and integration among the planning, budgeting, and program evaluation processes
- Assess legislative involvement in planning, budgeting, and program evaluation
- Assess the effectiveness of the planning process
- Assess the following issues related to the budgetary process:
  - Budget formulation
  - Budget format
  - Timing and flow of process
  - Budget execution
  - Capital planning and budgeting
- Assess the State's method for evaluating programs
  - Output versus outcome measures
  - In-depth program evaluations
  - Use of results from program evaluations

### **Audit scope**

The scope of this performance audit includes only the central, statewide planning, budgeting, and program evaluation processes. Although individual State agencies and the judicial and legislative branches contribute to these processes, all agencies must work within a central statewide system. The planning, budgeting, and program evaluation processes at individual State agencies are not included in this performance audit.

The statewide planning and budgeting processes are managed by the Office of State Planning (OSP) and the Office of State Budget and Management (OSBM). In the area of program evaluation, this performance audit covers both ongoing program evaluation, and periodic in-depth program evaluations. The program statistics collected by OSBM and reported in the budget represent the State's ongoing program evaluation process. Compliance and efficiency audits performed centrally by the Office of the State Auditor (OSA) are included in the scope.

### **Performance audit criteria**

Under the direction of the GPAC subcommittee on planning, budgeting, and program evaluation, we developed assessment criteria to evaluate the performance of State planning, budgeting, and program evaluation systems. The criteria were developed based on generally accepted management principles. The following assessment criteria were used to guide interviews and fact-finding and formed the basis for our assessment of the State's planning, budgeting, and program evaluation processes.

- The planning process should include the following components:
  - Analysis of external factors
  - Analysis of internal factors
  - Long-range horizon
  - Measurable results
  - Statewide priorities
  - Implementation plans
- The budget format should indicate statutory intent, allow meaningful comparisons among State funded activities, and tie proposed expenditures to program results
- The budget document should be brief yet comprehensive
- The budget formulation process should solicit relevant input from all parts of government, use accurate and current information, encourage a proper balance of staff input, and involve policy guidance at key points in the decision making process

- The budget execution process should hold agencies accountable for program results, encourage expenditure reductions, and discourage overspending
- Program evaluation should be ongoing and in-depth, based on program results rather than workload or outputs, and a key input into budgetary decisions
- Evaluation information should be sensitive to decisionmakers' needs and technical sophistication

These criteria are used in Section 3 to evaluate the effectiveness of North Carolina's current planning, budgeting, and program evaluation processes.

### **Methodology**

This section presents the methodology and work plan used to conduct the planning, budgeting, and program evaluation performance audit. The performance audit is being conducted in conformity with the Government Auditing Standards issued by the Comptroller General of the United States of America (i.e., the yellow book).

### **Preliminary survey**

Peat Marwick conducted a preliminary survey of the planning, budgeting, and program evaluation processes in the executive and legislative branches. The preliminary survey consisted of the following steps:

- Prepared preliminary audit survey plan and confirmed scope and approach with subcommittee
- Conducted preliminary review of documentation on the State's planning, budgeting, and program evaluation processes
- Interviewed top management responsible for planning, budgeting, and program evaluation processes in the legislative and executive branches
- Identified the state-of-the-art processes by:
  - Reviewing literature
  - Consulting professional associations and nationally known experts

### **Field work**

After completing the preliminary survey, Peat Marwick reported to the subcommittee, which identified the most important issues that required follow-up field work and analysis. For

the field work portion of the performance audit, Peat Marwick performed the following tasks:

- Reviewed alternative planning, budget, and program evaluation systems, including:
  - Zero-based budgeting
  - Planning-programming-budgeting system
  - Service efforts and accomplishments (GASB standards)
  - Mission driven budgeting
  - Output budgeting
  - Outcome budgeting
  - Customer driven budgeting
- Reviewed efforts toward budget reform in other states, including:
  - Florida
  - Iowa
  - Louisiana
  - Massachusetts
  - Oregon
  - South Carolina
  - Texas
- Interviewed key officials in other states
- Reviewed the history of North Carolina's budget formats
  - Line-item
  - Performance
  - Program
  - Current
- Developed flow charts of the planning, budgeting, and program evaluation processes
- Analyzed the State's current efforts at budget reform
- Conducted in-depth interviews with OSP, OSBM, OSA, the Fiscal Research Division (FRD), and other selected agency staff
- Assessed the State's capital budgeting process
- Reviewed the use of "sunset" legislation in other states

Based upon the standard criteria described in the previous section and our analysis of the current situation in North Carolina, we developed findings and recommendations.

### **Reporting**

In accordance with Phase I requirements, this report summarizes our major findings and recommendations as well as areas that warrant further analysis in Phase II.

## **2. CURRENT SITUATION**

This section presents the current situation in North Carolina relative to the State's planning, budgeting, and program evaluation processes. It is organized and presented in the following order:

- Budget pressures
- 1991-1993 State budget and recent budgetary reforms
- Planning, budgeting, and program evaluation processes

### **Budget pressures**

North Carolina can no longer manage its finances in the same way it did in the 1980s. During the 1980s, the high rate of economic growth furnished enough revenue annually to continue funding all State programs at their current levels with revenue to spare. This pattern reversed in 1987 and 1988, but the effect was obscured by a diversion of funds from the newly established Highway Trust Fund. It came to a halt abruptly in 1991 when negative revenue growth caused legislators to reexamine the relevance and effectiveness of existing State programs. Base level funding was cut, planned program expansions deferred, and taxes increased.

The State began to experience serious budgetary pressures during fiscal year 1990. In that year, the General Assembly deferred \$183.5 million for the 12th month pay period into fiscal year 1991, deferred \$38.9 million for income tax refunds, and withheld \$57.4 million from the Retirement System until the beginning of fiscal year 1991.

In 1991, North Carolina's fiscal problems grew to a crisis level. The State began the year with a \$222 million General Fund balance and ended it with \$400,000. To address its severe fiscal crisis, the General Assembly was forced to:

- Reduce and restrict hiring and operating expenditures
- Defer capital projects
- Draw down reserves
- Reduce non-recurring expenses
- Increase taxes by \$637 million
- Cut expenditures by \$576 million

Observers of state government management have noted a decline in North Carolina's ability to cope with these trends relative to other states. Exhibit 2-1 shows *Financial World's* annual ranking of states. From 1991 to 1992, North Carolina's rank fell from 8 to 16. Some of the reasons given for this drop were:

- Poor revenue estimating for fiscal 1991
- Weak expenditure estimates for Medicaid and the Department of Correction
- Efforts at performance measurement need greater focus on results
- Long delay in preparation of Combined Annual Financial Report (CAFR)

Oregon, on the other hand, rose in the rankings from 17 to 6 based on its long-range strategic planning, performance measurements, and expenditure estimation improvements.

Although North Carolina has slipped from the top ten states in the nation, it still remains a top performer. *Financial World* commended the State for the honest, straightforward way it handled its \$1.2 billion budget gap. The State is still one of only six states that qualifies for a triple A bond rating - the highest rating possible. In June 1992, Standard & Poor's, citing North Carolina's efforts to deal with the State's fiscal difficulties, removed a "negative credit outlook" from the State's credit rating.

Traditionally, funding for capital improvements has been a small part of the State budget and funded on a pay-as-you-go basis. However, in the 1991-1993 biennium, all funds were allocated to agency operating budgets, and all capital projects financed through the issuance of bonds.

The General Assembly took actions to resolve the fiscal crisis for the 1991-1993 biennium, but the State still faces a structural deficit over the next decade. A structural deficit refers to a deficit in General Fund revenue that results from projected expenditures exceeding projected revenue growth.<sup>1</sup> (See Exhibit 2-2.) The financial model requested by the General Assembly as a part of this performance audit projects that expenditures will increase at a faster rate than revenues. The result is a continuous gap between the level of general fund revenue that will be needed to continue State programs at their current level and the level of general fund revenues that will be generated under current law.

---

<sup>1</sup> Project General Fund revenues and expenditures for North Carolina are discussed in a separate report prepared for GPAC entitled *North Carolina Fiscal Outlook 1991-2002* by KPMG Peat Marwick, Policy Economics Group.



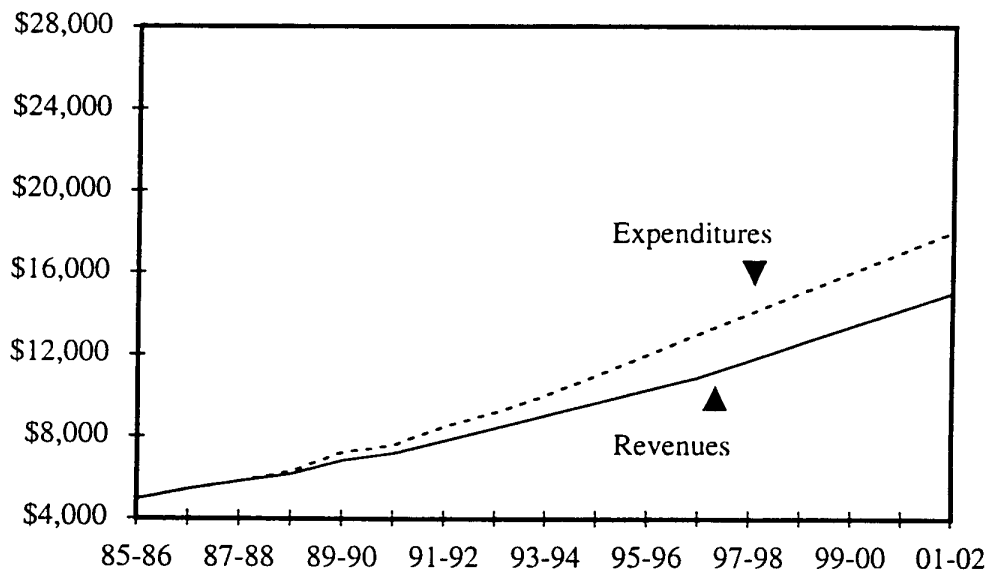
# Exhibit 2-1

## State Rankings by Financial Management Performance

<u>Rank</u>	<u>1991</u>	<u>1992</u>
1	Utah	Virginia
2	Missouri	Utah
3	Maryland	Missouri
4	Virginia	Maryland
5	South Carolina	Tennessee
6	Tennessee	Oregon
7	Washington	South Carolina
8	<b>North Carolina</b>	Wisconsin
9	Minnesota	Minnesota
10	Wisconsin	Florida
11	Indiana	Texas
12	Iowa	Washington
13	Nevada	Hawaii
14	Florida	Nevada
15	Hawaii	Delaware
16	Delaware	<b>North Carolina</b>
17	Oregon	New Jersey
18	Georgia	South Dakota
19	New Hampshire	Indiana
20	New Jersey	Georgia
21	Pennsylvania	Nebraska
22	Alabama	North Dakota
23	Mississippi	Iowa
24	Louisiana	Kentucky
25	Colorado	Arizona
26	Michigan	Arkansas
27	Texas	Pennsylvania
28	Ohio	New Hampshire
29	Arizona	Kansas
30	Montana	Connecticut
31	Nebraska	Colorado
32	South Dakota	Alabama
33	Alaska	Ohio
34	Arkansas	Michigan
35	Wyoming	Idaho
36	Illinois	Mississippi
37	Kentucky	Louisiana
38	Idaho	Rhode Island
39	Oklahoma	Oklahoma
40	Kansas	New York
41	California	Montana
42	North Dakota	Illinois
43	New York	Vermont
44	Rhode Island	West Virginia
45	New Mexico	New Mexico
46	Connecticut	California
47	West Virginia	Alaska
48	Maine	Maine
49	Vermont	Massachusetts
50	Massachusetts	Wyoming

Source: Financial World, May 12, 1992

**Exhibit 2-2**  
**Example of a Structural Deficit**



## **1991-1992 State budget and recent budgetary reforms**

The 1991-1992 State budget is \$13.6 billion. Of this amount, \$7.6 billion comes from the General Fund and \$6 billion comes from the federal government, department receipts, and highway trust funds. The General Fund sources are shown in the pie chart in Exhibit 2-3 and General Fund expenses are shown in Exhibit 2-4.

The sources of General Fund revenues include the following:

■ Personal income tax	47.0%
■ Sales tax	28.6%
■ Corporate income tax	7.8%
■ Other sources	13.8%
■ Non-tax Revenue	2.8%

The General Fund expenditures include the following:

■ Education	63.9%
■ Human Resources	16.8%
■ Justice and Public Safety	10.3%
■ Natural and Economic Resources	3.9%
■ General Government	2.9%
■ Other uses	2.2%

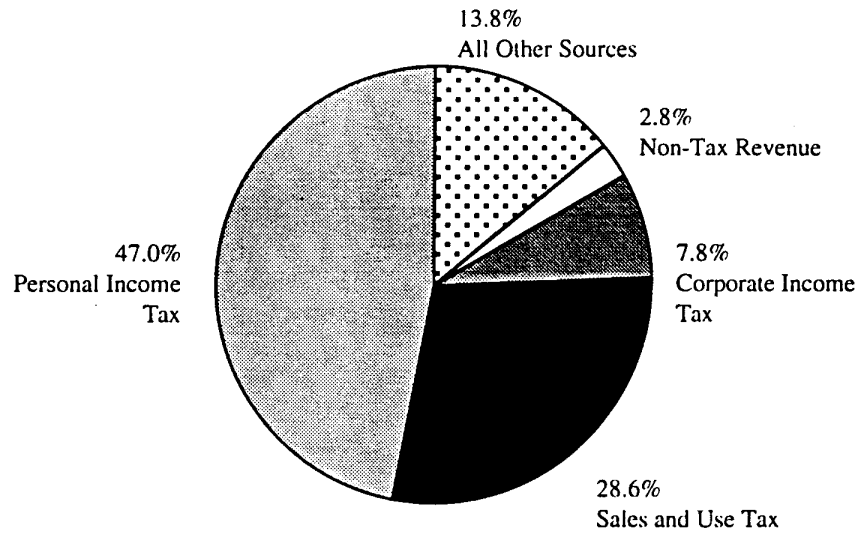
Human Resources and Justice and Public Safety have experienced tremendous growth in recent years largely owing to consent decrees and unfunded federal mandates. This trend places continuous fiscal pressure on the State and is expected to continue in the future.

The recent fiscal crisis caused the General Assembly to examine the State's budgetary process. In 1991, the General Assembly amended the Budget Act to include the following budgetary reform measures:

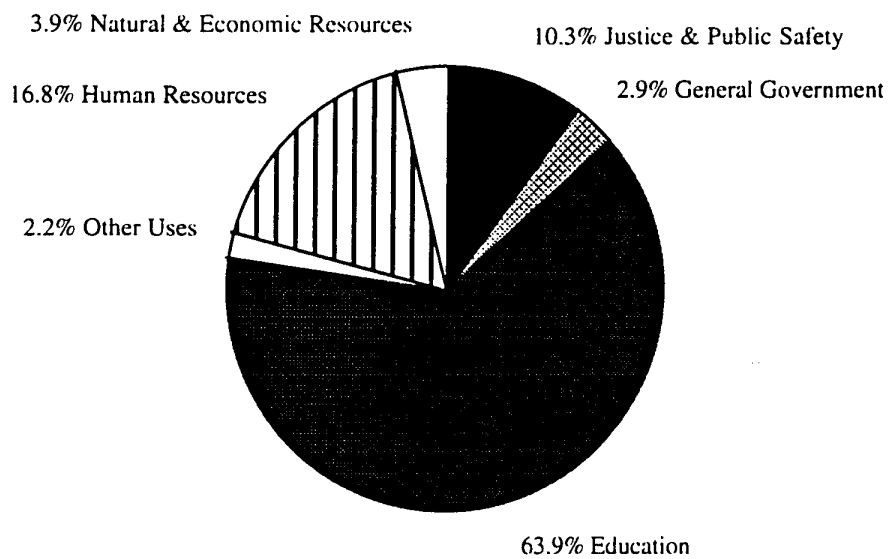
- Limited General Fund growth to growth in the income of State's citizens
- Established a repair and renovation reserve for State buildings
- Established a permanent rainy day fund (up to five percent of the General Fund budget), a method for funding it, and criteria for using it

Other areas of reform included projecting 20 years of operating costs for capital projects, projecting the cost of proposed legislation over 5 years, and the use of year-end balances for one-time expenditures.

### Exhibit 2-3 Source Of General Fund Revenues



### Exhibit 2-4 General Fund Expenditures



Source: Overview: Fiscal and Budgetary Actions, NC General Assembly 1991 Session

## **Planning, budgeting, and program evaluation processes**

Each department in North Carolina government now develops a six-year plan. The development of these plans is coordinated through the Office of State Planning in the Governor's Office. The plans are produced every two years consistent with the State's biennial budget process, and they are generally completed before the start of budget deliberations.

In the past, the Departments developed annual plans consistent with the requirements in G.S. 143A-17. These plans are to be submitted to the General Assembly. By agreement between the Governor and General Assembly, the biennial budget fulfills the statutory requirement for annual department plans.

In general, the North Carolina budget process is similar to that of the federal government and most other states and local governments. The Governor prepares an executive budget that includes proposed expenditures for all State departments and agencies over a two year period.<sup>2</sup> The budget is then transmitted to the General Assembly, which reviews and modifies the budget and votes an appropriations act. Once passed, the act becomes the State's budget over the next two years starting with July 1 of the odd-numbered year and ending on June 30 of the next odd-numbered year. The General Assembly meets in a short session in the even-numbered year to make any necessary adjustments to the budget.

The Office of State Budget and Management collects and publishes program statistics for all State agencies. These data are included in the budget document. Most of these program statistics measure workload and output rather than results. Consequently, the measures say nothing about program effectiveness. The process requires input from the agencies that update their program statistics biennially.

The Office of State Planning and the Office of State Budget and Management have been working to bring the planning, budgeting and program evaluation processes closer together. Currently, the two offices send out coordinated instructions for preparing the agency plan and the budget request. The efforts to introduce program budgeting to the State have required even closer cooperation between the two offices.

These process are discussed in more detail in Appendix A.

---

<sup>2</sup> North Carolina is one of 22 states that budgets on a biennial basis. Source: *Legislative Budget Procedures in the 50 States*, 1988, National Conference of State Legislators.

